ECONOMICS

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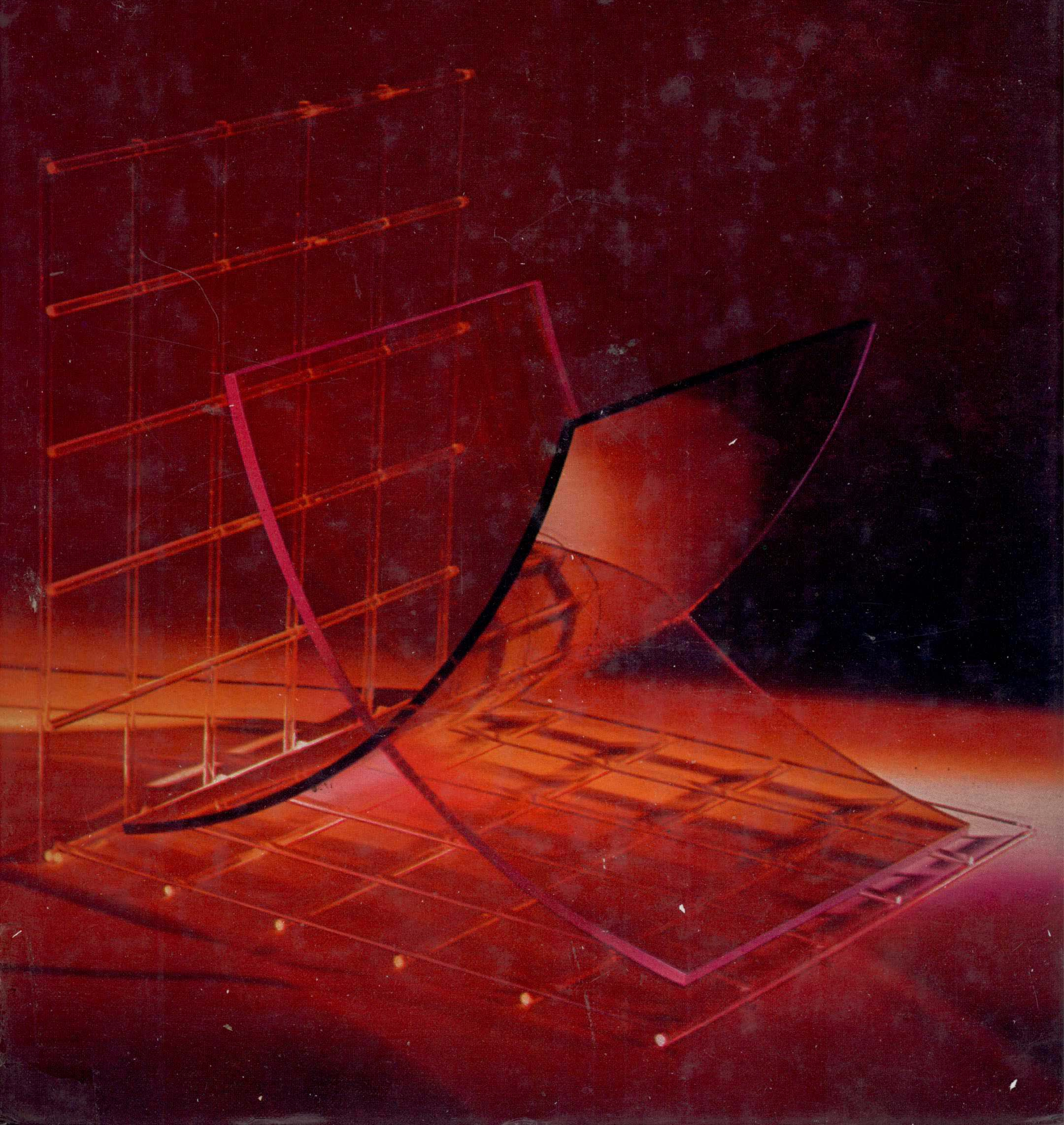

ECONOMICS

Paul Wonnacott

Professor of Economics
University of Maryland

Ronald Wonnacott

Professor of Economics
University of Western Ontario

McGraw-Hill Book Company

New York St. Louis San Francisco Auckland Bogotá Düsseldorf
Johannesburg London Madrid Mexico Montreal New Delhi
Panama Paris São Paulo Singapore Sydney Tokyo Toronto

Library of Congress Cataloging in Publication Data

Wonnacott, Paul.
Economics.

Includes index.
1. Economics. I. Wonnacott, Ronald J., joint author. II. Title.
HB171.5.W76 330 78-11067
ISBN 0-07-071571-8

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234567890 VHVH 7832109

This book was set in Caledonia by Black Dot, Inc. The editors were Bonnie E. Lieberman, Michael Elia, and J. W. Maisel; the designer was Merrill Haber; the production supervisor was John F. Harte. The drawings were done by J & R Services, Inc.
Von Hoffmann Press, Inc., was printer and binder.

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Preface

Economics is like the music of Mozart. On one level, it holds great simplicity: Its basic ideas can be quickly grasped by those who first encounter it. On the other hand, below the surface there are fascinating subtleties that remain a challenge even to those who spend a lifetime in its study. We therefore hold out this promise. In this introductory study, you will learn a great deal about how the economy works—the simple principles governing economic life that must be recognized by those in government and business who make policy decisions. At the same time, we can also guarantee that you won't be able to master it all. You should be left with an appreciation of the difficult and challenging problems of economics that remain unsolved.

Perhaps some day you will contribute to their solution.

HOW TO USE THIS BOOK

We have tried to design this book to make the basic propositions of economics as easy as possible to grasp. Key steps in the argument and essential definitions are emphasized with a red shaded background. These highlights should be studied carefully during the first reading, and during later review. (A glossary is provided at the back of the book, containing a list of definitions of terms used in this book plus other common economics terms that you may encounter in class or in readings.) The basic arguments of each chapter are summarized in the Key Points at the end of the chapter, and the new concepts of the chapter are also listed.

When you read a chapter for the first time, don't worry about what is in the boxes. This material is optional; it is set aside from the text to keep the main argument as simple and straightforward as possible. (Several types of material are presented in the boxes. Some boxes provide levity or color—for example, Henry Manne's parable of government regulation of the parking lot business on p. 498, and Kurt Vonnegut's tale on p. 676 of the Handicapper-General whose aim is to ensure that people will not only start out equal but also finish that way. Other boxes present detailed theoretical explanations, that are not needed to grasp the main argument.) If you want to glance at the boxes that are fun and easy to read, fine; but don't worry about those that contain more difficult material. Also skip starred (*) sections of the text, along with the footnotes and appendices; these also tend to be more difficult. Come back to them later, as a way of expanding your knowledge and understanding, but only after you have mastered the basic ideas. And listen to your instructor, who will tell you which of the boxes and starred sections are most important for your course.

Economics is not a spectator sport. You can't learn just from observation; you must work at it. When you have finished reading a chapter, work on the problems listed at the end; they are designed to reinforce your understanding of important concepts. Because each chapter builds on preceding ones, and because the solution to some of the problems depends on those that come before, remember this important student's rule: Don't fall behind in a problem-solving course. To assist you in this objective, we recommend Peter Howitt's *Study Guide*, which is designed specially to assist you in working through each chapter; it should be available in your bookstore.

TO THE INSTRUCTOR

In adding one more volume to an already heavily populated field, authors of any new introductory economics text have a substantial responsibility to provide something new. We make no claim to revolutionary innovations. But we do believe that there is room for improvement in the presentation of elementary economics.

In particular, we have aimed at three major objectives. The first two grew out of questions that arose in our teaching—and out of our uneasiness regarding the answers.

For macroeconomics, the question was this. After studying introductory economics, are students able to understand public controversies over such topics as the level of government spending and taxation, the desirability of wage and price controls, and monetary policy? Are we training our students to understand the front page of the newspapers? For many years, the introductory course was aimed at teaching students how policy should be run; that is, at providing a cookbook of "right" answers. While many books express more doubts and qualifications than was the case a decade ago, we have altered the focus of the course even more substantially by building up to the five unsolved, controversial questions dealt with in the chapters of Part 3: Is fiscal policy or monetary policy the key to aggregate demand? How can inflation and unemployment exist at the same time? Why is the economy unstable? To what extent should we attempt to fine-tune the economy? Should exchange rates be fixed or flexible? While there are no simple, indisputably "correct" answers to these questions, we believe that the major issues can be presented clearly to beginning economics students, thereby providing them with an understanding of important, recurring public debates over macroeconomic policy.

For microeconomics, the disturbing question was this. After macroeconomics, is microeconomics a letdown? Too often, we fear that the answer has been yes. We were particularly concerned by the responses when we conducted an informal poll regarding the age-old question of whether macro or micro should be studied first. A common reply was that macro should come first, because it is needed to whet the appetites of beginning students. Even more disconcerting was the response from some universities that teach micro first (including one of the nation's most distinguished): Students should be made to take micro first as a ticket for entry into the more rewarding macro course; if they are given the option, few will take micro. Although universities are not prosecuted under the antitrust laws, we are nevertheless appalled at this "full-line forcing" of what some regard as the bitter microeconomic pill.

The problem with microeconomics, it seems to us, is that it tends to become just one thing after another—a guided tour through the economist's workshop, introducing students to as many polished pieces of analytic machinery as possible for later use in more advanced courses. But most students do not continue in economics. For them, there is little point in mastering analytic techniques for their own sake, when the time could be spent discussing interesting policy issues instead. Even for those who do continue in economics, we doubt that it is useful to invest so heavily in analytic techniques. True, this gives students some headstart in their later courses; but it also increases the risk that they will be bored by repetition. Therefore, we have followed a simple rule: If a concept is not necessary to analyze a policy issue, we don't introduce it.

Microeconomics can, in our view, be made more interesting (and acute indigestion can be avoided) by organizing the course around two continuing themes: *efficiency* and *equity*. Initially, our major focus is on efficiency, with the emphasis on marginal (rather than total or average) curves, and on consumers' and producers' surpluses. For efficiency, equating marginal cost and marginal benefit is the key; hence the emphasis on the marginal concept. And the study of marginal curves leads naturally to consumers' and producers' surpluses, which are building blocks for the study of income distribution. In emphasizing marginal concepts, we have tried to give students an appreciation of what allocative efficiency means: Why it is highly desirable to produce the goods that consumers demand. But we have also tried to show why it is not the last word. In particular, we have discovered that elementary students can fairly easily be shown what many in the past discovered only in graduate school: There is a different efficient solution for each income distribution; hence a solution that is efficient is not necessarily best.

Thus, the study of efficiency leads naturally to the study of the second major microeconomic objective, equity. In recent years, this topic has increased in importance: As our income has grown, we have been redistributing an increasing slice of it. In Part 4 in our discussion of product markets (where the major focus is on efficiency), we also explicitly consider how a policy change will affect income distribution. Similarly, in our discussion in Part 5 of factor markets (where the major focus tends to be on income distribution), we also emphasize how a policy change will affect efficiency.

In our treatment of macroeconomics, we have also tried to keep the theoretical discussion cleanly focused on a few main themes. This has meant leaving out some common tools and steps, particularly those that tend to be roadblocks. And it has meant putting in other steps or concepts which are needed to tie the argument together.

For example, our presentation of the basic Keynesian theory of income determination is leaner in some respects, and more detailed in others, than the standard textbook treatment. Specifically, many books introduce Keynesian economics with a discussion of saving and investment (and sometimes Say's law). Although this approach accurately reflects Keynes' concerns in attacking "classical economics," it has several pedagogical shortcomings. Most important, it constitutes a roadblock. Saving and investment (and Say's law) tend to be mysterious to the beginning student, and to turn the weaker students off. [There are equally grave problems for the better students. Not only do they wonder how classical economists could have been so wrong—a question which naturally arises when a critic's (Keynes') arguments are used to explain classical theories—but they are also sometimes puzzled by the lack of coherence in classical thought. Indeed, the very best may correctly wonder whether Say's law is not inconsistent with the quantity theory. In order to avoid these problems, we emphasize the more sensible part of classical economics, namely, the quantity theory, and exile Keynes' favorite target—Say's law—to an appendix.]

Rather than start with saving and investment, we introduce Keynesian economics with a discussion of aggregate demand and its determinants. Aggregate demand for the nation's total product follows naturally from the concept of demand for an individual product, which students have already studied in Chapter 4. Later, after the consumption function has been introduced and its close ties with its twin (the saving function) explained, equilibrium at the point of equality between intended investment and saving can be mastered as a single additional step.

Other potential roadblocks that have been omitted, downplayed, or set aside in optional boxes include liquidity preference and the IS and LM curves. Liquidity preference is not needed to explain the effect of monetary policy on interest rates; discussion of the effect of open-market operations on the supply and demand for bonds will do (p. 221). Liquidity preference was, of course, featured in Keynes' theory; he used it to explain why expansive monetary policy might not work during a depressed period of very low interest rates. But that was a special case. While it was important in the 1930s, it is much less important in the modern world of high interest rates. It is therefore put in a box (p. 246) explaining the special problems of the depression. IS and LM curves have been omitted because they are difficult, and because many of the propositions derived from them can be deduced more directly and more easily in some other way.

On the other hand, some material not commonly found in introductory texts has been added to throw light on the main themes or to allow the argument to proceed in smaller, more easily understood steps. For example, the effect of proportional taxes on consumption has been explained (p. 175) as a way of bridging the gap between a lump-sum tax and automatic stabilizers.

These, then, are our three main objectives: To provide an understanding of vexing current policy issues in the macro chapters; to provide coherence and interest to the micro chapters by focusing on the major themes of efficiency and equity; and to make the exposition proceed in small, orderly steps.

OTHER POINTS OF INTEREST

Finally, we draw your attention to a number of ways in which our treatment differs from that of many competing books.

• Because of our emphasis on major themes and problems, our discussion of international economics is organized differently than that in most books. The gains from trade and the effects of protection fit into the topic of efficiency, and therefore are included in Part 4 (Chapters 25 and 26). But the question of exchange rate arrangements is related to such policy issues as inflation and unemployment, and to such theoretical concepts as the quantity theory of money. It is therefore included with other macroeconomic topics in Part 3 (Chapter 16). By keeping international topics close to related domestic topics, we hope to counteract the neglect of international economics in many introductory courses.

Similarly, our treatment of other important topics—like agriculture, urban problems, or the oil price increase—is not confined to one chapter. Instead, each of these topics reappears. For example, the oil price increase is discussed first in our macroeconomic discussion of the price level (Chapter 13), and again in microeconomics (Chapters 22 and 30), where we consider its effect on efficiency and the distribution of income. Nor is there a separate chapter on growth; instead it is a recurring theme throughout the book.

- In emphasizing efficiency and the gains from specialization, we have given greater attention to economies of scale than is frequently the case. Indeed, in Chapters 3 and 25, economies of scale are given billing almost equal to comparative advantage.

- Students are introduced to the important idea of dynamic efficiency. Any concrete analysis of dynamic efficiency has traditionally been regarded as too difficult for an elementary course. Initially we sympathized with this view, until we discovered that most elementary students can indeed handle a problem like the most efficient pattern of resource use over time. (See optional Box 30-3.)

- Should indifference curves be included in an elementary book? We are very much of two minds. On the one hand, we don't see great value in the indifference curve demonstration that a demand curve typically slopes downward and to the right. (Every analysis must start somewhere, and we find a downward-sloping demand curve a more appealing starting point than indifference curves in an introductory course.) But we recognize that our view is not shared by all; consequently we include indifference curves in the Appendix to Chapter 18 to show the standard results. But more important—in an application not typically attempted in books at this level—we use indifference curves (in an Appendix to Chapter 20) to demonstrate the efficiency of perfect competition. (But we also illustrate this important result more simply in the text itself, using only supply and demand curves.)

- We show how conflicts exist not only between policy objectives (such as equity and efficiency) but also between groups of people in the economy. To illustrate: Under standard assumptions the theory of comparative advantage shows how opening foreign trade can bring an efficiency gain. A nation's real income can increase as a consequence. But in this book we go one step further to emphasize how opening trade will also redistribute income. Low-cost imports benefit consumers, but also damage competing domestic producers. In this case, the interests of these producers and consumers are in conflict. In analyzing such microeconomic issues we constantly ask, "Who benefits, and who gets hurt?" We find that it is very easy for students to identify gainers and losers: Any policy that changes a price will benefit some group and damage another. When students develop this feel for who gains and who loses, they can then appreciate the irony of complaints about agricultural price supports that come from business executives who benefit from protective tariffs that prop up the prices of the goods *they* produce. And students who have learned about the gains from trade will not be shaken when some business executives or labor leaders attack foreign imports. Instead they will recognize this to be the normal reaction of a group that is being damaged by imports, rather than a convincing case against what they learned in introductory economics. Moreover, this identification of different groups (and the different degrees of political power exercised by each) helps the student naturally to answer one of the basic questions raised by the theory of public choice: Why is there a difference between what the government *should* do, and what it *does* do?

• Other topics on which we have placed more-than-usual emphasis include externalities (Chapters 23 and 24), the difficulty of policymaking when inflation and unemployment coexist (Chapter 13), and financial instability (Chapters 6 and 14). The gold standard is discussed in some detail because students show a surprising and continuing interest in it. And it can be used to explain and illustrate some of the sources of financial instability in United States history. Furthermore, in a era of high rates of inflation and dollar instability on the foreign exchanges, it is important to explain why a return to the gold standard does not represent a simple solution.

ALTERNATIVE COURSE DESIGNS

As already noted, some of the boxes in the text are used to introduce material that may be too difficult for some students, but highly enlightening for good ones. (See, for example, Box 20-2 on Pareto efficiency and Box 21-1 on the theory of the second best.) We hope that these boxes, along with similarly designed footnotes and appendices, will give you flexibility in pitching this course at the level you wish. Moreover, if you have a particularly good class, you can take them even further with the material provided in the *Instructors' Manual*—which you may reproduce as you wish for class distribution. (Regardless of the level of your class, we recommend that you assign Peter Howitt's *Study Guide.*)

In a further attempt to design the book with maximum flexibility, we have brought all the macro chapters together into Parts 2 and 3, and all the micro chapters together into Parts 4 and 5. The majority who teach macro first can use the chapters in order. Those who wish to cover micro first can cover Parts 1, 4, 5, 2, and 3 in that order.

For instructors teaching a one-semester course, there are two paperback options: *An Introduction to Macroeconomics* and *An Introduction to Microeconomics.* Those who wish to cover both macro and micro quickly in one semester should drop most boxes and appendices, and then use: Chapters 1 to 11, 17 to 19, and Chapter 20 up to p. 445; Chapter 21 to p. 470, Chapter 22, Chapter 23 to p. 511, Chapters 24, 25, 27, 28, and Chapter 29 to p. 638, Chapter 30 to p. 657, Chapter 31, Chapter 32 to p. 692, and Chapter 33 to p. 708.

We Wish to Thank . . .

It is impossible for authors to develop an introductory text without accumulating enormous intellectual debts along the way. For their thoughtful criticisms and suggestions, we should like to thank Professors Elisabeth Allison, Charles Brown, Michael Butler, David Conklin, Dudley Dillard, Mark Frankena, Peter Howitt, Sol Kaufler, Kathleen Langley, Allen F. Larsen, Paul Meyer, Lars Osberg, John Palmer, Martin Perline, Hugh Peters, Jonas Prager, Allen R. Sanderson, Marvin Snowbarger, William Tabel, Tom Wonnacott, Donald Yankovic—and, especially David Laidler.

At an early stage, extremely helpful assistance was provided by those who taught this book in an unpolished preliminary form: Professors Lloyd C. Atkinson of American University, Heidemarie C. Sherman and Allen R. Thompson of the University of New Hampshire, and Frank D. Tinari of Seton Hall University. To them—and to the hundreds of students in their classes—we express our deepest thanks.

Paul Wonnacott
Ronald Wonnacott

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